DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

CC:EBEO:Br.4EMadden
FREV-113027-99

OCT 14 1999

MEMORANDUM FOR DIRECTOR, EXEMPT ORGANIZATIONS DIVISION,
OP:E:EO
Attn: Bob Fontenrose

FROM: Assistant Chief Counsel
Office of the Associate Chief Counsel (Employee Benefits and Exempt Organizations), CC:EBEO

SUBJECT: [redacted]

This responds to your request for assistance dated July 26,1999, regarding a private letter ruling request submitted by the above-referenced taxpayer. Because we previously advised you by telephone that the rulings involving sections 401(h), 419, and 419A of the Internal Revenue Code and the portion of the ruling concerning section 401(h) and the tax benefit rule should be forwarded to the Employee Plans Division, this memorandum only responds to your request for assistance regarding the remaining portion of the ruling about the tax benefit rule.

<u>LEGEND</u>:

Company = [redacted]

The relevant facts, as we understand them, are as follows. Company sponsors the Medical Plan, which generally provides health-related benefits for eligible active and retired employees. The Medical Plan consists of a Core Program, which is the medical program, and a Supplemental Program, which is the dental, vision care, behavioral health, and Medicare Part B premium reimbursement program.

Prior to January 1, 1999, the Voluntary Employees' Beneficiary Association of the Non-represented Employees of Company (the Old VEBA) covered Supplemental Program postretirement benefits for all active employees of Company (and their spouses and dependents) who were not covered by a collective bargaining agreement (noncollectively bargained employees) and all former noncollectively bargained employees, but excluded any employees or retired employees who were key employees within the meaning of section 416(i) of the Code. There was no aggregate limit on the dollar amount of Supplemental Program benefits payable by the Old VEBA. All assets in the Old VEBA were attributable to employer contributions. The Old VEBA was previously granted exempt status under section 501(c)(9) of the Code. The Old VEBA's trust agreement generally provides that no trust assets shall ever revert to or inure to the benefit of Company or be used for any purposes other than the payment of benefits under the plans funded through the Old VEBA.

Prior to January 1, 1999, the section 401(h) account covered Core Program postretirement benefits for all retirement plan participants who were noncollectively bargained employees and all former noncollectively bargained employees who retired after December 31, 1992. Retired key employees, within the meaning of section 416 of the Code, and their spouses and dependents are ineligible for benefits under these accounts. All assets in these accounts are attributable to employer contributions. The retirement plan provides that in no event, prior to satisfaction of all liabilities under the retirement plan to provide covered health care benefits, shall any amount in the 401(h) account be used for any purpose other than the payment of such benefits and related administrative expenses. Any amounts in the 401(h) account following satisfaction of all such liabilities must be returned to Company. Company received a favorable determination letter with respect to the qualified status of the retirement plan under section 401(a).

Effective as of January 1, 1999, Company amended the Old VEBA and the 401(h) account provisions of the retirement plan and established the New VEBA (the Restructuring). The 1999 amendments to the Old VEBA generally expand the category of benefits eligible for coverage, limit membership to certain classes of individuals, and impose a limit on the aggregate amount of benefits for retired employees with respect to each calendar quarter.

Specifically, the Old VEBA will cover all postretirement benefits payable under the Core and Supplemental Programs. The Old VEBA limits membership to current retired employees who retired after December 31, 1992, and to active employees who are eligible for certain special "grandfathered" pension benefits under the retirement plan and their respective eligible spouses and dependents. The Old VEBA continues to exclude employees or retired employees who are, or were, "key employees" within the meaning of section 416(i) and active and retired collectively bargained employees. As a result of the 1999 amendments, the Old VEBA provides that postretirement benefits will not be payable from the Old VEBA to the extent that they exceed a certain threshold amount for any calendar quarter, unless such benefits are not paid by Company directly or from the 401(h) account. If the amount in the 401(h) account is insufficient to pay the benefits otherwise payable through the 401(h) account, the Old VEBA and the New VEBA (as applicable) would pay the excess (to the extent funded) for their respective members.

In 1999, Company established the New VEBA effective January 1, 1999, as another funding medium for the Core and Supplemental Programs. Company intends to submit a request for a favorable determination letter regarding the exempt status of the New VEBA as a VEBA under section 501(c)(9) of the Code.

The New VEBA will cover all postretirement Core and Supplemental Program benefits. Membership in the New VEBA is limited to active Company employees and retired employees who retire after March 31, 1999, and their respective spouses and dependents who are not members of the Old VEBA. In effect, the New VEBA limits membership to those active and retired employees (and their eligible spouses and dependents) who are ineligible for certain special "grandfathered" pension benefits under the retirement plan (the nongrandfathered group). The New VEBA excludes employees or retired employees who are, or were, "key employees" within the meaning of section 416(i) and active and retired collectively bargained employees. The New VEBA provides that postretirement benefits will not be payable to the extent that they exceed a certain threshold amount for any calendar quarter. If the amount in the 401(h) account is insufficient to pay the benefits otherwise payable through the 401(h) account, the Old VEBA and the New VEBA (as applicable) would pay the excess (to the extent funded) for their respective members. The trust agreement for the New VEBA generally provides that (except with respect to contributions made due to a mistake in fact or to pay Trust expenses), no trust assets shall ever revert to or inure to the benefit of Company or be used for any purposes other than the payment of benefits under the plans funded through the New VEBA, as permitted by law. All assets in the new VEBA are attributable to employer contributions.

As a result of the amendments to the Old VEBA and the establishment of the New VEBA, all members of the nongrandfathered group will be transferred from the Old VEBA to the New VEBA effective January 1, 1999. Nongrandfathered group members will then be eligible for benefits under the new VEBA rather than the Old VEBA. Members of the grandfathered group will not be transferred to the New VEBA, but will continue to be eligible for benefits under the Old VEBA.

The portion of assets of the Old VEBA attributable to the nongrandfathered group members who are transferred from the Old VEBA to the New VEBA will be transferred to the New VEBA as soon as practicable following Company's receipt of a favorable ruling from the Service. The transfer amount will be an amount allocated to the New VEBA based on the portion of the total present value of all future covered medical benefits, reflecting current medical costs, attributable to members to be covered by the New VEBA. The actuarial present value will be calculated as of December 31, 1998, based on the same projected benefits and actuarial assumptions used in the determination of the December 31, 1998, account limit for the Old VEBA. The transfer of assets from the Old VEBA to the New VEBA does not affect the type of benefits provided under either VEBA. Each VEBA will continue to pay benefits under the Medical Plan to its respective members subject to the applicable limits. Assets transferred from the Old VEBA to the New VEBA will not involve the transfer of any assets from one employee benefit plan to another.

Company has amended the retirement plan effective January 1, 1999, to cover a portion of all Supplemental and Core Program postretirement benefits through the 401(h) account. These amendments also limit the aggregate amount payable from the 401(h) account for any calendar quarter with respect to retired employees and their beneficiaries who are members of the Old VEBA and the New VEBA. The limit is equal to the excess of the total cost of benefits otherwise payable from the 401(h) account over the maximum threshold amounts provided under the Old VEBA as amended, and the New VEBA.

Company requests the following ruling, a portion of which is within our jurisdiction:

> 5. The Restructuring will not result in the realization or recognition of gross income, or loss of prior tax deductions, by Company (or its subsidiaries) for any year.

Assuming the above-described facts are included in the ruling letter, we suggest that you also include the following:

> Section 1001(a) of the Code provides, in part, that the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain. Section 1001(b) generally provides that the amount realized from the sale or other disposition or property shall be the sum of any money received plus the fair market value of the property (other than money) received. Under section 1001(c), except as otherwise provided in Subtitle A of the Code, the entire amount of the gain or loss, determined under section 1001 on the sale or exchange of property shall be recognized.
>
> Section 111(a) of the Code provides that gross income does not include income attributable to the recovery during the taxable year of any amount deducted in any prior taxable year to the extent such

amount did not reduce the amount of tax imposed by this chapter. This section, in part, codifies the "tax benefit" rule.

In Hillsboro National Bank v. Commissioner, 460 U.S. 370 (1983), the Supreme Court held that income may arise under the tax benefit rule even though there is no actual recovery of funds that were previously deducted. All that is required is that an event occur in the current year that is "fundamentally inconsistent" with the premise on which the deduction was taken in a prior year.

Section 1.501(c)(9)-4 of the Income Tax Regulations provides that whether prohibited inurement has occurred is a question to be determined with regard to all the facts and circumstances. For example, paragraph (d) provides that prohibited inurement will arise upon the termination or dissolution of a VEBA if all existing liabilities of the organization are not satisfied, to the extent of any remaining assets. It further provides that if the trust document or charter provides for the reversion of assets to the employer on dissolution or if the reversion is permitted through operation of law, the trust or organization is not described in section 501(c)(9).

Company will not realize or recognize gross income under section 1001 of the Code due to the Restructuring. Implicit in the definition of amount realized in section 1001(b) is a requirement that the property be owned by the taxpayer for tax purposes. Because the assets in the Old VEBA and the New VEBA cannot inure to the benefit of Company under section 1.501(c)(9)-4 of the regulations, Company is not entitled to the benefits or burdens of such assets. Without an amount realized there cannot be recognition of gross income under section 1001(c). Thus, the Restructuring will not cause Company to realize or recognize gross income.

Company will not recognize income under the tax benefit rule due to the transfer of assets from the Old VEBA to the New VEBA. Contributions to the Old VEBA and the New VEBA are deductible under sections 419 and 419A of the Code (or their predecessor, if applicable). Additionally, the governing instruments of the Old VEBA and the New VEBA prohibit amounts from reverting to the benefit of Company as required by section 1.501(c)(9)-4 of the regulations. Both VEBAs provide postretirement medical benefits. The transfer of funds from Old VEBA to New VEBA as part of the Restructuring is not fundamentally inconsistent with the premise on which Company deducted amounts contributed to the Old VEBA. Thus, Company will not recognize income under the tax benefit rule on the transfer of assets from the Old VEBA to the New VEBA due to the Restructuring.

Similarly, Company will not recognize income under the tax benefit rule due to the amendment of the Old VEBA.

Accordingly, we rule as follows:

5. The Restructuring will not result in the realization or recognition of gross income [or loss of prior tax deductions][1] by Company (or its subsidiaries) for any year.

If you have any questions regarding this memorandum, please contact Erinn Madden in my office. Ms. Madden may be reached at (202) 622-6060.

Assistant Chief Counsel
MARY OPPENHEIMER

By: ______________________
Mark Schwimmer
Chief, Branch 4

[1]This portion of the ruling is under the jurisdiction of the Employee Plans Division and thus subject to their concurrence.